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Japanese Economy Remains Strong

The Japanese economy, having demonstrated its ability over shorter distances, now is beginning to look strong in the marathon as well. Pending confirmation next month by the gross national product statistics, already-released data virtually affirm that growth continued in the last quarter of 1988, ensuring a good full-year performance.

Industrial production, for example, continued to surge and ended the year 9.4 percent ahead of 1987. December figures were up 0.5 percent on a seasonally adjusted basis from the previous month, putting them 8.4 percent ahead of December 1987. Although inventories grew for the fourth straight month, they still are at historically low levels, suggesting Japanese manufacturers are making only modest progress in catching up with exceptionally strong demand.

Japanese consumers, at least those who did their December shopping in department stores, continued to do their part, with an increase in spending of

But Japanese firms have a good track record of late for sizing up their customers fairly wisely and adjusting their operations appropriately. Staying abreast of the fleet-footed Japanese consumer and his fickle foreign counterpart is no mean challenge, but, on the evidence of the past year, Japanese firms have demonstrated an ability to keep pace, without getting too far ahead.

Douglas Ostrom

Current Account Surplus Shrinks In 1988

Normally, a hoped-for event that was eight years in coming would be cause for celebration. Yet few could muster much joy on the release of Japan's 1988 current account figure, which showed the first calendar year decline in the surplus since 1981 when Japan's string of surpluses began. The widely watched comprehensive measure of Japan's trade status was down 8.7 percent to \$79.5 billion, putting it below not only last year's mark but the 1986 level as well (see Table 1). Yet many had hoped for more improvement. A year ago Tokyo had expected a 12.2 percent decline in the huge surplus, to \$72 billion, in the fiscal year that ends March 31. The latest figure reduces further the already unlikely prospect that the government's projection will be reached.

Table 1: Japan's Balance of Payments

(in millions of dollars, IMF value basis)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988*</u>
Current Account	\$35,003	\$49,169	\$85,845	\$87,015	\$79,488
Trade Balance	44,257	55,986	92,827	96,386	94,789
Exports (f.o.b.)	168,290	174,015	205,591	224,605	259,555
Imports (f.o.b.)	124,033	118,029	112,764	128,219	164,766
Services	-7,747	-5,165	-4,932	-5,702	-11,167
Transfers	-1,507	-1,652	-2,050	-3,669	-4,134
Long-Term Capital	-49,651	-64,542	-131,461	-136,532	-130,326
Basic Balance	-14,648	-15,373	-45,616	-49,517	-50,838
Short-Term Capital	-4,295	-936	-1,609	23,865	19,536
Errors and Omissions	3,743	3,991	2,458	-3,893	2,320
Overall Balance	-15,200	-12,318	-44,767	-29,545	-28,982

*Preliminary.

Source: Bank of Japan

The reason for the pessimism is contained in the October-December figures, which showed a 6.1 percent jump in the surplus over the same period a year earlier. Rising exports swamped the other components of the current account, a result largely anticipated by the customs-clearance trade figures released earlier (see JEI Report No. 5B, February 3, 1989).

Huge current account surpluses imply large net capital outflows, which may be long-term, short-term or governmental. In recent years Japan, in effect, has financed its trading partners' current account deficits through enormous long-term capital outflows that sometimes have been larger than necessary to

finance the deficits, permitting small net inflows of other kinds of funds. Early in 1988, however, several analysts expressed concern that these long-term capital flows were drying up, that Japanese investors were losing interest in overseas markets. They speculated that the Japanese government was making up the difference, although the full extent of government intervention was unknown. By the end of the year, lost confidence, if any, was restored, as reflected in the continuing long-term capital outflow.

While this outflow showed little change from 1987, its components indicated that Japanese investors, if anything, were more positive about foreign investment than the year before (see Table 2). The 1987 figure was inflated as Americans and others fled the Tokyo stock market both before and after the worldwide stock market crash in October 1987, swelling the net capital outflow. In other words, panicky Americans helped finance the U.S. current account deficit in 1987. Although Americans and other foreigners withdrew funds from the Japanese bond market in 1988, they reversed course on stocks, adding to their holdings, making them much less of a factor that year in long-term capital flows.

Table 2: Net Long-Term Capital Flows

(in millions of dollars)

	<u>1987</u>			<u>1988*</u>		
	<u>Outflows</u>	<u>Inflows</u>	<u>Net</u>	<u>Outflows</u>	<u>Inflows</u>	<u>Net</u>
Direct Investment	\$-19,519	\$1,165	\$-18,354	\$-34,138	\$-489	\$-34,627
Trade Credits	-535	-1	-536	-6,678	-12	-6,690
Loans	-16,190	-119	-16,309	-14,942	-82	-15,024
Securities	-87,757	-6,081	-93,838	-87,135	20,303	-66,832
Stocks	-16,874	-42,835	-59,709	-2,993	6,810	3,817
Bonds	-72,885	6,675	-66,210	-85,812	-21,628	-107,440
Yen-Denominated						
Bonds Issued in						
Japan	2,002	n.a.	2,002	1,670	n.a.	1,670
External Bonds**	n.a.	30,079	30,079	n.a.	35,121	35,121
Other	-8,829	1,334	-7,496	-6,393	-760	-7,153
Total	-132,830	-3,702	-136,532	-149,286	18,960	-130,326

Note: A negative sign indicates a capital outflow.

*Preliminary.

**Bonds issued outside of Japan by Japanese institutions.

Source: Bank of Japan

Among outbound capital flows, direct investment, which was up 74.9 percent, showed the largest percentage increase in 1988. While full-year figures are not available, data through June 30, 1988 showed that 59 percent of these funds went to the United States. The rise in direct investment here and elsewhere is clearly a dual response to currency appreciation. In addition to

reducing the costs of overseas property when expressed in yen, a stronger currency has led Japanese firms to try to save money by producing goods and services overseas.

As Table 2 shows, securities, especially bonds, continue to account for the lion's share of Japanese investment abroad. In the first half of 1988, 53 percent of these funds went to the United States. Together, the figures on direct investment and securities suggest the significant extent to which Japanese investors have opted to put their foreign investment eggs in an American basket.

While a net capital outflow at any point in time is the mirror image of the current account surplus, over time the investments can lead to a larger surplus as interest and other income flows back to Japan. Japan's net international investment income rose \$4.5 billion in 1988, reflecting Japan's emergence as the world's largest creditor, but rapidly rising tourism expenditures more than offset this effect, pushing the overall services account further into deficit for the second straight year (Table 1). One of the questions for the 1990s is whether Japanese tourists will continue to proliferate abroad faster than Japanese investments. If not, the already tough job of reducing Japan's current account surplus will become commensurately more difficult.

Douglas Ostrom

Japan-EC Trade, Investment Rise

Japan's ties with the European Community are growing by leaps and bounds in the trade and the investment fields. Just as it has with the United States, however, this increased interdependence does not mean a reduction in frictions for Japan. In addition, the transition to a more interdependent relationship is complicated by the EC's drive to unify its internal common market starting in 1992, which is rekindling debate on many dormant bilateral issues. Although EC leaders insist that the 1992 integration will not create a "fortress Europe," it is clear that reciprocity and local content requirements will mold the shape of foreign access to the unified European market.

The state of bilateral trade differs greatly when viewed in dollars as opposed to yen (see Table). While Tokyo can claim that its trade surplus with the 12-member community declined slightly in yen terms for 1988, Japan's surplus rose nearly 14 percent when translated into dollars. What is undeniable in either yen or dollar terms is that both the value of imports and the overall value of bilateral trade is growing swiftly. Growth in purchases from the EC outpaced the expansion of Japan's exports to the group in both 1987 and 1988. Yet, because the absolute value of imports is about half that of exports, the growth rate for Japan-bound goods must be at least twice as high as export growth to keep the trade gap from widening. That is why EC leaders continue to prod Tokyo to increase imports even though purchases clearly are enjoying healthy growth.

In return, Tokyo is hoping that the community will drop or ease many EC-level restrictions on inbound Japanese products and that nationally imposed restrictions will go the same way. Bilateral talks that ended February 10 led to some progress: EC negotiators agreed to lift the quantitative restrictions on 41 of 131 items from Japan and will consider freeing the remaining 90. West

Germany, Denmark and Ireland held out the promise of dropping all existing national curbs against Japanese goods, while France, Italy, Spain, Greece, Belgium, Luxembourg and the Netherlands agreed to partial liberalizations. Portugal was the odd man out, refusing to lift any of its 23 import bans. Britain did not participate in the talks. Despite some progress, items of greatest concern to Japan, including cars, consumer goods and electronic equipment, remained sensitive issues; they often were omitted from the lists of goods to be liberalized. Another round of talks has been scheduled, and Tokyo remains hopeful of further progress.

Japanese direct investment in Europe also is booming. According to the Japan External Trade Organization, the number of Japanese-owned plants on the continent rose from 282 in 1987 to more than 400 by the end of last year. Between fiscal years 1983 and 1987, according to the Ministry of Finance, cumulative Japanese investment in Europe rose from \$115 million to \$797 million in the transportation equipment industry, nearly tripled in the electric/electronic machinery field to \$704 million, and doubled in the area of pharmaceuticals and chemicals. The services sector, too, is not being ignored: much of the \$2.5 billion that was poured into Britain and the \$1.8 billion that was funneled into Luxembourg in FY 1987 can be totted up to the increased activities of Japanese finance and insurance companies.

European governments view this impressive growth with some qualms. On the one hand, they have been urging Japan to increase investment and decrease exports for years. The EC's antidumping rules on finished products as well as on imported components make investment in local plant and equipment almost mandatory. Now that Japanese firms are sharply raising overseas investment, however, European fears have revived that domestic industry will be swamped.

This revival has led to the imposition of local content requirements for a growing range of goods. London and Paris are locked in a confrontation over whether cars produced in Britain by Nissan Motor Co., Ltd.'s subsidiary are British or Japanese. Paris is insisting that the vehicles must have 80 percent British content. London and Nissan (and, indirectly, the EC) say that the current 60 percent British composition is sufficient. At stake is unhindered access to the French market for the locally produced cars. The United States now is caught in the crossfire on this issue. The EC decided February 10 to extend its 20 percent antidumping duty on copiers brought in from Japan to copiers assembled in Ricoh Co., Ltd.'s California plant and shipped to the community, claiming that the "Made in U.S.A" label is a smokescreen. The decision warns that as long as an item subject to an antidumping-duty order contains a significant share of parts made by a company liable for extra duties, the EC will apply dumping duties regardless of the country of origin of the final product. This interpretation threatens to incur the wrath of American firms with their extensive overseas assembly and production networks.

Even this antidumping rule change may not be enough, some European policymakers worry. A parade of investment announcements by Japanese firms with a strong commitment to both local production and parts procurement surely will translate into greater market share and much stiffer competition for domestic producers. Toyota Motor Corp. expects to build a major auto plant in Britain. Other Japanese car makers already have wholly owned plants or tie-ups with European firms or are investigating the situation. Among semiconductor makers, at present only NEC Corp. has a completely integrated operation within the community. In response to the EC's decision to impose a local content requirement

Japan's Trade with the European Community

(in millions and percent change)

a. in yen

	<u>Exports</u>		<u>Imports</u>		<u>Balance</u>	
	<u>Value</u>	<u>Change</u>	<u>Value</u>	<u>Change</u>	<u>Value</u>	<u>Change</u>
European Community						
1988	Y6,002,067	9.4%	Y3,082,596	20.2%	Y2,919,471	-0.1%
1987	5,487,963	6.1	2,564,847	9.2	2,923,116	3.5
Britain						
1988	1,361,791	11.6	536,179	21.0	825,612	6.2
1987	1,220,781	8.7	443,096	-25.3	777,685	-16.3
West Germany						
1988	2,022,659	8.1	1,037,624	16.2	985,035	0.7
1987	1,871,028	5.9	893,045	23.1	977,983	-6.0
France						
1988	638,604	9.4	552,844	33.0	85,760	-49.0
1987	583,796	9.7	415,691	33.4	168,105	-23.8
Italy						
1988	356,715	16.9	370,051	18.9	-14,336	-135.2
1987	305,111	5.1	311,206	24.1	-6,095	*

b. in dollars

	<u>Exports</u>		<u>Imports</u>		<u>Balance</u>	
	<u>Value</u>	<u>Change</u>	<u>Value</u>	<u>Change</u>	<u>Value</u>	<u>Change</u>
European Community						
1988	\$46,867	24.3%	\$24,069	36.2%	\$22,798	13.9%
1987	37,693	22.9	17,670	26.3	20,023	20.0
Britain						
1988	10,630	26.5	4,189	37.0	6,441	20.5
1987	8,400	26.4	3,057	-14.5	5,343	73.9
West Germany						
1988	15,795	23.1	8,109	31.8	7,686	15.0
1987	12,833	22.5	6,150	43.1	6,683	8.1
France						
1988	4,986	24.2	4,313	50.2	673	-41.2
1987	4,014	27.4	2,871	54.8	1,143	-11.8
Italy						
1988	2,786	32.5	2,893	35.5	-107	-234.3
1987	2,103	5.1	2,135	42.8	-32	*

*Meaningless.

Source: Ministry of Finance

on integrated circuits, Fujitsu, Ltd. and Toshiba Corp. have announced their intention to add wafer fabrication plants to their existing European assembly and testing facilities. Some European governments are studying even more complex local content requirements, perhaps mandating a certain amount of local research and development or engineering work before a product is considered "European."

In an effort to bring this trend to a halt, Tokyo and some private Japanese business organizations are exploring the development of international standards for country-of-origin rules. The goal is to avoid the worst possible situation of every country establishing its own criteria for "domestic" and "foreign" goods, creating a maze of nontariff barriers. While Japan certainly prefers that there be no such rules anywhere, a uniform standard would be superior to classification chaos. Whether this idea will take off is uncertain at best; skeptics point to the difficulties encountered in harmonizing EC-member views on plans for 1992 and the difficult Uruguay Round of multilateral trade negotiations as examples of what can happen. In any event deeper, stronger Japan-EC relations clearly are generating new problems as they solve old ones and exacerbate still others. The challenges for policymakers are growing, not decreasing, but so are the rewards.

Jon Choy

FSX Stirs Concerns About Japanese Technology Grab

Bilateral joint development of Japan's next-generation fighter support aircraft -- hailed by some U.S. defense officials as the first step in a new era of U.S.-Japan defense cooperation -- may be jeopardized by growing criticism from a number of Americans of what they contend is the proposal's adverse economic implications. Although a government-to-government accord was concluded last November, congressional criticism of certain provisions of the agreement as well as a lack of consensus within the administration regarding the broader economic ramifications of joint weapons development ultimately may derail the deal. A series of negative editorials and op-ed pieces in prominent newspapers, such as the New York Times and the Journal of Commerce, have further fanned the fires. The common theme of these critiques is that the American side concluded this agreement without adequate attention to the long-term implications for U.S. industry and the trade balance.

After more than a year of protracted negotiations, the United States and Japan signed a memorandum of understanding November 29, 1988 stipulating that Mitsubishi Heavy Industries, Ltd. would be the lead company to design and build a new defense aircraft based on General Dynamics Corp.'s F-16 fighter aircraft. General Dynamics, which looked on the FSX project as an invaluable way to improve the F-16, was designated the main American subcontractor. It and other American companies are guaranteed approximately 35 to 45 percent of the research and development work.

Despite the MOU provisions, MHI and General Dynamics remained at loggerheads over the division of research and development -- principally in the area of wing design. The wings will be made from composite materials using the most sophisticated MHI technology. General Dynamics, which wants to use this know-how to upgrade its F-16's wings, argued that only by participating in prototype production could it gain the necessary knowledge. MHI had been reticent about transferring the proprietary technology due, in part, to concerns that it would